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## **RECONCILING RULES OF ORIGIN AND GLOBAL VALUE CHAINS: THE CASE FOR REFORM**

Colleen Carroll  
Dylan Geraets  
Arnoud R. Willems



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## ABSTRACT

Rules of Origin (ROO) are in need of reform. Aside from being used for protectionist purposes, they have also become so complicated that they result in companies foregoing trade preferences granted by preferential agreements on a substantial scale. This paper makes the argument for a fundamental reconceptualization of ROO, based on today's Global Value Chains (GVCs). The paper is divided in four sections. First, it surveys the methods currently applied for assigning origin. Existing obstacles to reform are then outlined. A third section briefly examines previous attempts at reforming ROO. Fourth, the contours and possible ramifications of a value-added approach to determining origin are explored, given that (a) ROO are not suitable for today's world characterized by GVCs; and (b) the tension between bilaterally established rules and multilateral decision-making continues to hamper attempts at harmonization or reform.

## KEYWORDS

WTO, Trade, Rules of Origin, Global Value Chains, Made in the World.

## AUTHORS

**Colleen Carroll** and **Dylan Geraets** are PhD candidates and Research Fellows at the Leuven Centre for Global Governance Studies – Institute for International Law, KU Leuven.

**Arnoud R. Willems** is a partner at Sidley Austin, LLP.

## ADDRESS FOR CORRESPONDENCE

[Colleen.Carroll@ggs.kuleuven.be](mailto:Colleen.Carroll@ggs.kuleuven.be)  
[Dylan.Geraets@law.kuleuven.be](mailto:Dylan.Geraets@law.kuleuven.be)

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## TABLE OF CONTENTS

<b>1.</b>	<b>Introduction: What's Wrong with the ROO Picture .....</b>	<b>4</b>
<b>2.</b>	<b>What are Rules of Origin, and How is Origin Determined?.....</b>	<b>5</b>
A.	Preferential Rules of Origin.....	6
B.	Non-Preferential Rules of Origin .....	7
<b>3.</b>	<b>Resolving the Problems Associated with ROO Complexity — a New Approach.....</b>	<b>9</b>
A.	Trade Diversion .....	9
B.	ROOs as Instruments of Protectionism.....	10
C.	Foregoing Preferential Status and Failing to Utilize PTAs .....	10
<b>4.</b>	<b>Complex Rules leads to Underutilization .....</b>	<b>11</b>
<b>5.</b>	<b>Origin: Tariff Reduction or Increased Business Costs? .....</b>	<b>12</b>
<b>6.</b>	<b>Toward a Value-Added Approach .....</b>	<b>13</b>
A.	Multilateral approaches to ROO Harmonization.....	14
B.	Bilateral Relations: a New Starting Point for ROO Reform .....	17
<b>7.</b>	<b>Conclusions .....</b>	<b>19</b>

# RECONCILING RULES OF ORIGIN AND GLOBAL VALUE CHAINS: THE CASE FOR REFORM

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## 1. INTRODUCTION: WHAT'S WRONG WITH THE ROO PICTURE

When implementing customs and trade policies and setting tariffs with trading partners, nothing is more important than knowing where goods originate. Rules of Origin (ROO) provide a set of procedures for determining this location and work to ensure that only selected trading partners benefit from tariffs installed via trade agreements. But while intended to facilitate international trade and keep free riders from profiting unwarrantedly from free trade areas, ROO have backfired. Not only are they increasingly abused for protectionist purposes — most controversially for the imposition of anti-dumping duties —, but also so muddled that companies either forego preferences to which they are legitimately entitled or decline to trade with producers in countries where they would otherwise benefit from comparative advantage. In both cases, production costs rise and consumers suffer.

Current ROO date back to the 1950s and determine origin predominantly on the (presumably single) location of manufacturing and assembly. But as the World Trade Organization (WTO) describes it, products are no longer made in a single country, but rather are “Made in the World.” The trend toward ‘global factories,’ where products are produced in multiple steps and locations, vitiates the practice of focusing on one location of ‘final manufacturing’. Classifying final goods proves complicated, as manufacturing and processing occur across vertically integrated companies spanning the globe and intermediate goods for one product might be a final good sold by a subsidiary. Moreover, the steps of R&D, design, development, and marketing increase a product’s value such that as little as 10% of its total value might be added in the country where the “end product” is manufactured.

The obvious solution to these problems is reform. Historically, attempts to reform, simplify, or harmonize ROO have surfaced only at the multilateral level. However, multilateral approaches have reached an impasse since the Agreement on ROO at the end of the Uruguay Round negotiations of the GATT in 1994. After that, the focus shifted to preferential ROO and as a result, the most important ROO are now established in Regional Trade Agreements (RTAs) or PTAs signed between states, each with unique specifications. While this shift to bilateral and plurilateral agreements has resulted in an increasing complexity of ROO, it also creates opportunities to explore new approaches. The best way forward may be to apply reconceptualized.

Overhauling ROO and instead focusing on the total supply chain can help recapture the benefits of trade liberalization. Producers can again make rational decisions about where to locate manufacturing and assembly, source materials, and place R&D and marketing activities. As the Organization for Economic Co-operation and Development (OECD), the WTO and the United Nations Conference on Trade and Development (UNCTAD) stated in a joint report for the G20 Summit in Saint Petersburg, “trade agreements have to cope with the new reality of business.”

Reformed ROO might contribute to making Preferential Trade Agreements (PTAs) more 'GVC-friendly' and increasing their impact on the productivity of countries and companies.<sup>1</sup>

Cognizant of the current global business and political conditions, this paper argues that reform must go beyond pragmatic steps such as harmonization or 'rebalancing'. Instead, a fundamental reconceptualization of ROOs is needed based on today's global value chains (GVCs).<sup>2</sup> To make a convincing case for reform, this paper proceeds in four successive sections. First, it surveys the methods currently applied for assigning origin. Existing obstacles to reform are then outlined. A third section briefly examines previous attempts at reforming ROO. Fourth, the contours and possible ramifications of a value-added approach to determining origin are explored, given that (a) ROO are not suitable for today's world characterized by GVCs; and (b) the tension between bilaterally established rules and multilateral decision-making continues to hamper attempts at harmonization or reform.

## 2. WHAT ARE RULES OF ORIGIN, AND HOW IS ORIGIN DETERMINED?

ROO are key components of a state's customs and trade policies designed to identify a manufactured product's location of origin. They exist to facilitate exchange between countries partner to an RTA or PTA, as a good originating in a country party to the agreement is taxed at a lower rate at the border; they simultaneously deflect non-partner country goods from profiting from the favorable tariff rates. ROO exist "not to make life complicated or miserable for exporters or importers, but.... to ensure that only qualified parties and products benefit from the RTA and there are no Free Riders."<sup>3</sup> In this light, the *raison d'être* of ROO has been described as differentiated restrictions on international trade,<sup>4</sup> pending universal liberalization and eventual elimination of barriers. Discussions about ROO cannot be separated from efforts to harmonize trade policy and to liberalize trade on a global scale.

ROO determine the tariff levied on each product imported into a country, they facilitate trade statistics, and support a multitude of other trade-related policies. Though ensconced via political decision-making, ROOs influence investment and sourcing decisions at the firm level. ROO can be used to create conditions needed to ensure that partnering countries benefit from preferential tariff schemes. However, sound or universal application of the rules is difficult because the outdated geographical distinctions embedded in ROO confer different tariffs on, or treatments of, imported goods. Determining origin has also proven controversial because the application of ROO fluctuates widely from state to state and from agreement to agreement, and because the system for determining 'originating' and 'non-originating' products is so complex.

Importantly, ROO are divided into two distinct types: preferential ROO and non-preferential ROO, the latter also referred to as 'economic origin'. Preferential and non-preferential origin can be calculated and applied quite differently (often at the same time), leading to different scenarios in which a variety of actors — importers, exporters, customs officials, various producers in a production chain, etc. — are impacted in divergent ways. As the name indicates, preferential rules of origin are used to determine whether a product originates in a country with which the importing country has concluded a PTA or RTA. Hirsch explains: "ROO are primarily designed to

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<sup>1</sup> G20, "Implications of Global Value Chains for Trade, Investment, Development and Jobs", Joint Report by the OECD, WTO, UNCTAD, 6 August 2013, p. 19.

<sup>2</sup> Sébastien Mirodout and Dorothée Rouzet (2013), 'Trade Policy Implications of Global Value Chains: Contribution to the Report on Global Value Chains', OECD, TAD/TC/WP(2012)31/FINAL, at 28. See also Olivier Cadot and Jaime de Melo (2008), "Why OECD Countries Should Reform Rules of Origin", World Bank Research Observer, (23) (1), 77-105.

<sup>3</sup> Ann Van de Heetkamp and Ruud Tusveld (2011a), "Why Is this Complex?", *Origin Management*, Springer Publishing, Heidelberg, pg. 183-190 at 183.

<sup>4</sup> Edwin Vermulst, Rules of Origin as Commercial Policy Instruments – Revisited, 1992 *Journal of World Trade* (26)(6), 61-102 at 61.

facilitate trade liberalization through reciprocal arrangements. This method is widely implemented through the conclusion of preferential agreements intended to allow trade concessions only to the contracting parties, while *maintaining* existing barriers towards non-contracting parties.”<sup>5</sup> Non-preferential ROO, on the other hand, are used to justify less-favored treatment for non-contracting parties. At the risk of oversimplifying, preferential ROO qualify a product for a benefit whereas non-preferential ROO target a product for a penalty.

In theory, proper deployment of both types of ROO would appropriately modulate trade flows, rewarding trade partners while still allowing states party to an RTA to execute external tariffs on goods from non-agreement countries. In practice, however, this complex system has abetted harmful activities such as protectionist policy-making and costly trade diversion and deflection. To understand how, we need to understand how each type of ROO defines the origin of a product.

#### A. PREFERENTIAL RULES OF ORIGIN

Preferential ROOs generally confer preferential treatment on a product based on one or any combination of the following four rules, all of which are spelled out in the Free Trade Agreement to which both states are party. Origin is conferred if (i) the product is identified as wholly obtained within a partner country, meaning that all products involved in the final good are sourced from countries party to this RTA. Alternatively, (ii) origin is assigned where the transformation of the exported product in RTA countries increases its value, or a significant transformation of the product is completed within the partnering countries. Another rule (iii) is the “Change of Tariff Classification”; this means that a product “originates” in the country where the Harmonized System (“HS”) code of the manufactured product differs from the HS codes of its components.<sup>6,7</sup> This Change of Tariff Classification test is the most frequently applied for determining preferential origin. Because every RTA contains its own set of rules for origin determination, and because HS codes are continuously amended, producers must constantly re-evaluate sourcing and production patterns, as fluctuations in HS codes trigger fluctuations in prices of production materials and associated costs.<sup>8</sup> Moreover, HS classifications, maintained by the World Customs Organization (WCO), were not designed with ROO in mind. The fourth rule (iv) consists of a specific rule. Indeed, sometimes, the country of origin can be defined by a specific tailor made rule for a product. For example, the EU determined that an electronic product such as a radio or video could only originate in the country where the transistor originated. However, sometimes it is so difficult to meet the origin test for preferential treatment that companies simply abandon the effort, defeating the purpose of the PTA.

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<sup>5</sup> Moshe Hirsch, *International Trade Law, Political Economy and Rules of Origin A Plea for a Reform of the WTO Regime on Rules of Origin*, 2002 *Journal of World Trade* (36)(2) 171-188, at 177.

<sup>6</sup> The Harmonized System code (HS code) stems from the International Convention on the Harmonized Commodity Description and Coding System. This convention was concluded in 1983 with the aim of facilitating trade and enabling the collection of trade related statistics. The harmonized system devised by the convention lays down a nomenclature comprising headings and subheadings of different goods. The convention obliges contracting parties to make use of the Harmonized System in the application of customs tariff and statistical nomenclatures. The six-digit HS codes are contained in HS Nomenclatures that are amended every five years. The Revised Kyoto Convention (RKC) entered into force in 2006, and was developed by the successor of the CCC, the World Customs Organization (WCO). It specifies in Article 4 of Special Annex K that ‘In applying the substantial transformation criterion, use should be made of the International Convention on the Harmonized Commodity Description and Coding System.’ See World Customs Organization, ‘International Convention on the Simplification and Harmonization of Customs Procedures (as amended), 2006.

<sup>7</sup> Ann Van de Heetkamp and Ruud Tusveld (2011b), “(Rules of) Origin”, *Origin Management*, Springer Publishing, Heidelberg, pg. 71-108 at 72-73.

<sup>8</sup> Stefano Inama (2009a), “Drafting Preferential Rules of Origin,” in *Rules of Origin in International Trade*, Cambridge University Press, New York, p. 426.

## B. NON-PREFERENTIAL RULES OF ORIGIN

The 1974 International Convention on the Simplification and Harmonization of Customs Procedures (Kyoto Convention), written under the auspices of the Customs Co-operation Council (CCC), contains the specifics for determining a product's non-preferential origin.<sup>9</sup> Two separate methods are used to determine non-preferential treatment. First, where only one (non-member) country is involved in the attribution of origin, origin is defined by the country where the product is "wholly produced."<sup>10</sup> Second, the country of origin is determined to be the country where the "last substantial transformation took place". The vagueness of the Convention's wording leaves considerable scope for interpretation.<sup>11</sup> The Kyoto Convention only serves as a guide and lacks any binding power as an international legal instrument; this means the Kyoto Convention did not effectively harmonize non-preferential determination, leaving the door open to case-by-case abuse of the procedure for protectionist purposes.<sup>12</sup> Resultantly, non-preferential ROO can lead to de-facto higher tariffs on goods from non-member countries, inducing producers or exporters to divert trade patterns to countries with lower tariffs and distorting trade.

In addition to the two methods described above, two additional tests can be used to confer non-preferential origin on a product. First, the country contributing the highest value to a specific good's final value can be designated the product's country of origin. Second, the country of origin for non-preferential goods can be determined by identifying the location where the last substantial transformation takes place; this can be "the country where the good changed character, was significantly processed, or where final assembly took place."<sup>13</sup> Under the Special Committee on Preference's review of Rules of Origin, definitions of final transformation stemmed from standing European Economic Community definitions, where final transformation results in "the manufacture of a new product," or represents "an important state of manufacture."<sup>14</sup> Importantly, these tests are generally applied when tests for preferential origin are incapable of identifying origin. As with other methods, these tests can be misused. For example, it is possible to unfairly penalize a given producer by defining its products as non-preferential through incorrect identification of a non-member country of 'last substantial transformation.'

Non-preferential origin rules enable straightforward tasks like collecting trade statistics and applying labeling and marking requirements. Indeed, "the most common application for non-preferential rule of origin is arguably labeling."<sup>15</sup> Non-preferential tariffs are also applied in government procurement. However, they can also be invoked for a variety of political purposes, such as achieving direct trade outcomes or indirect trade goals. Most controversially, they are used to implement anti-dumping duties and safeguard measures.<sup>16</sup> In anti-dumping matters, non-preferential ROO are relevant both during an anti-dumping investigation and after imposition

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<sup>9</sup> The Revised Kyoto Convention (RKC) entered into force in 2006, and was developed by the successor of the CCC, the World Customs Organization (WCO). It specifies in Article 4 of Specific Annex K that 'In applying the substantial transformation criterion, use should be made of the International Convention on the Harmonized Commodity Description and Coding System.' See World Customs Organization, 'International Convention on the Simplification and Harmonization of Customs Procedures (as amended), 2006.

<sup>10</sup> Article 2 of Specific Annex K., Chapter 1.

<sup>11</sup> World Customs Organization, 'Rules of Origin in Kyoto Convention: Definitions, Principles, Standards and Recommended Practices', Available at <http://www.wcoomd.org/en/topics/origin/instrument-and-tools/comparative-study-on-preferential-rules-of-origin/specific-topics/general-topics/kyoto-topic.aspx> (last accessed 17 April 2014).

<sup>12</sup> Mitsuo Matsushita, Thomas J. Schoenbaum and Petros C. Mavroidis, *The World Trade Organization – Law, Practice, and Policy* (Second Edition), Oxford University Press, Oxford, 2006, 989p., at 266.

<sup>13</sup> See van de Heetkamp and Tusveld (2011b), above n 7, at 75.

<sup>14</sup> Regulation 802/68, from Commission Regulation 2454/93, as quoted in Inama (2009a), above n 8, at 401.

<sup>15</sup> See van de Heetkamp and Tusveld (2011b), above n 7, at 73.

<sup>16</sup> See van de Heetkamp and Tusveld (2011b), above n 7 at 71. See also Ivo Van Bael and Jean-François Bellis (2011), "Circumvention", *EU Anti-dumping and other Trade Defence Instruments*, Kluwer Law International, pg.629-666 at 661.

of anti-dumping measures.<sup>17</sup> Investigative authorities may use ROO in the first stage of investigation to determine whether dumping is transpiring and whether dumping is causing material injury to the domestic industry producing the 'like' product; in the second stage, producers hit by the anti-dumping duties may decide to relocate their production and initiate or increase export from a third country. In order to address this issue of "circumvention" and avoid opening a new anti-dumping investigation, the authorities (customs, the European Anti-Fraud Office (OLAF), the trade defense unit of the European Commission), "may dispute the origin of the products now coming from such countries and conduct an origin investigation."<sup>18</sup>

The application of ROOs when executing trade mechanisms like safeguard and anti-dumping measures underscores major divisions with the WTO's Committee on Rules of Origin, wherein Members continue pursuing a harmonized set of non-preferential ROOs. Contentions arise concerning ROOs in other trade measures, as well, including most-favoured nation treatment, countervailing duties, origin marking and labeling, discriminatory quantitative restrictions, government procurement, and trade statistics.<sup>19</sup> Despite proposals to grant Members permission to choose the instruments where ROOs would be applied, harmonization efforts are further complicated by diverging views on the identification of rules for the machinery sector. Preferences here are split between a rules system rooted in the change of tariff classification and a newer approach anchored in value added at each stage of transformation. Efforts remain stagnated since 2006, and the Committee cites a lack of political guidance from the WTO's General Council as a primary cause for continuing deadlocks in the harmonization process.<sup>20</sup>

In the European Union (EU), the Basic Origin Regulation was the first step taken by the EEC to harmonize the different non-preferential origin rules prevailing in EC Member States.<sup>21</sup> The substantive origin rules provided by the Basic Origin Regulation have been characterized as 'extremely succinct and vague.'<sup>22</sup> Article 5 of the Regulation provides that:

"a product in the production of which two or more countries were concerned shall be regarded as originating in the country in which the last substantial process or operation that is economically justified was performed, having been carried out in an undertaking equipped for the purpose, and resulting in the manufacture of a new product or representing an important stage of manufacture."

The Court of Justice of the European Union (CJEU) has been asked on a number of occasions to interpret this particular provision of the European Economic Community (EEC) Basic Origin Regulation.<sup>23</sup> The resulting body of case law exemplifies the importance of the interpretation of terms such as 'last substantial process' and 'important stage of manufacture'. For example, in the Brother II case, the Hauptzollamt Giesen ordered Brother to pay 3.2 million Deutsch Mark in Anti-Dumping duties because the typewriters did not originate in Taiwan- as Brother had

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<sup>17</sup> Stefano Inama and Edwin Vermulst (2010), "Nonpreferential Origin Rules in Antidumping Law and Practice", Law and Economics of Contingent Protection in International Trade, Cambridge University Press, Cambridge, pg. 276-305 at 283.

<sup>18</sup> Ibid, at 292.

<sup>19</sup> WTO document G/L/1047, "Report (2013) of the Committee on Rules of Origin to the Council for Trade in Goods," (2013).

<sup>20</sup> Ibid.

<sup>21</sup> Council Regulation (EEC) No 802/68 on the common definition of the concept of the origin of goods, O.J. (1968) L 148/165 [Regulation 802/68 or Basic Origin Regulation]. This Regulation was repealed by Council Regulation (EEC) No 2913/92 establishing the Community Customs Code, O.J. (1992) L 302.

<sup>22</sup> Paul Waer, European Community Rules of Origin, in Edwin Vermulst, Paul Waer and Jacques Bourgeois (eds.), Rules of Origin in International Trade, 1994, University of Michigan Press, Ann Arbor, 501pp., at 98.

<sup>23</sup> Case 49/76 Gesellschaft für Überseehandel v Handelskammer Kassel [1977] ECR 41 (Überseehandel); Case 114/78 Yoshida GmbH v Industrie- und Handelskammer Kassel [1979] ECR 151 (Yoshida); Case 162/82 Criminal proceedings against Paul Cousin and others [1983] ECR 1101 (Cousin); Case 93/83 Zentralgenossenschaft des Fleischgewerbes e.G. v Hauptzollamt Bochum [1984] ECR 1095 (Zentrage); and Case 26/88 Brother International GmbH v Hauptzollamt Giesen [1989] ECR 4253 (Brother II).



claimed- but rather in Japan. Brother conceded that most of the parts originated in Japan but argued that the assembly of the parts in Taiwan constituted a classical operation of transformation within the meaning of Article 5 of the Basic Origin Regulation.<sup>24</sup> The Court of Justice reaffirmed that the decisive criterion in Article 5 of the Basic Origin Regulation is that of the ‘last substantial process or operation’. Since Article 5 did not specify the extent to which assembly operations could be regarded as a substantial process or operation, the Court relied on Rule 6 of the Kyoto Convention, which provides a definition of ‘simple assembly operations’. It held that where only two countries are concerned in the production of a good, the mere assembly of previously manufactured parts is insufficient to confer origin on the country of assembly if the value added in assembly is appreciably less than the value imparted in the other country. The Court further added that in situations where the added value of assembly constitutes less than 10%, origin cannot be conferred upon the country of assembly in any event.

Even for the same product, preferential origin determination may provide very different outcomes than those resulting from non-preferential origin determination. As Vermulst notes, “[p]referential ROO] are completely immaterial for determining whether the same products fall within the scope of trade-restrictive measures such as quotas or antidumping duties.”<sup>25</sup> Non-preferential methods may be used when preferential methods fail, sometimes leading to the identification of multiple countries of origin. Interpreting state specific non-preferential ROOs- and as exemplified in the Brother case, the spider web of case law stemming from this process- complicates and increases the cost of both upholding and complying with the current system of origin rules.

### **3. RESOLVING THE PROBLEMS ASSOCIATED WITH ROO COMPLEXITY — A NEW APPROACH**

Originally designed to deter non-signatory states from free riding preferential tariff rates installed via RTAs, ROO are increasingly one of the most complex mechanisms in international trade. For example, numerous RTAs contain different ROO, there are two distinct but overlapping ROO types and a plethora of unique situations for applying origin rules, and myriad tests deduce appropriate origin classifications; multiple ambiguities and thorny procedures interlinked with ROO generate several interrelated problems. The most burdensome of these are threefold: trade diversion, the failure of companies to seek preferential status, and protectionist tactics. What follows touches briefly on trade diversion and protectionism, but because changes in production and consumption patterns have reshaped the conditions for economic exchange, the bulk of discussion coalesces around the (under)utilization of preferential terms.

#### **A. TRADE DIVERSION**

ROOs can divert exporters and importers from trading with producers in countries where it would otherwise be economically advantageous. Van de Heetkamp and Tusveld note that “[o]rigin issues are intertwined in compliance, cost-benefit analysis, and sourcing options,” issues that increase costs associated with production.<sup>26</sup> Heightened costs are absorbed by the business, decreasing the firm’s profitability, or (more likely) are passed on to consumers, who then must pay a higher price to compensate for fees associated with determining origin or the higher tariff rates for non-originating products.

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<sup>24</sup> Case 26/88 Brother International GmbH v Hauptzollamt Giesen [1989] ECR 4253 (Brother II), para. 15.

<sup>25</sup> See Vermulst, above n 4, at 80.

<sup>26</sup> See van de Heetkamp and Tusveld (2011a), above n 3, at 183.

## B. ROOS AS INSTRUMENTS OF PROTECTIONISM

Hirsch argues that ROO may also be instruments of domestic protectionism: “Generally, as more local materials and processes are employed in the manufacturing of a product, the likelihood of meeting the origin requirements increases. Thus, the inclusion of more stringent ROOs in a preferential agreement generates a greater incentive for producers to use more local materials and intermediate components.”<sup>27</sup> The presence and concentration of domestic interest groups benefitting from the current status quo, then, are an important consideration. Recent trade liberalization negotiations conducted by the EU, for example, espouse friction between reducing tariffs and use of origin rules. Where tariff reduction schemes bias one country over the other, ROOs can be more heavily or closely monitored as a way to protect domestic industries from an increasing number of imports. For instance, such a maneuver would allow the automotive industry to pressure domestic authorities to more rigorously monitor origin requirements from trade partners so that origin of essential car components, such as engines, tires, window glass, are accounted for in calculating appropriate tariff rates. The European Automotive Manufacturers’ Association issued statements to this degree, demanding equal tariff liberalization schedules and unbiased access in agreements negotiated with India and South Korea.<sup>28,29</sup>

## C. FOREGOING PREFERENTIAL STATUS AND FAILING TO UTILIZE PTAS

Besides problems of trade diversion and protectionist tactics, ROO may induce companies to forego the preferences granted by RTAs. Assuming full utilization of preferences, the 2011 World Trade Report found that only 16 percent of a sample covering imports of the 20 largest importers (excluding intra-EU trade) from all their trading partner countries qualified as preferential trade.<sup>30</sup> This indicates that preference utilization rates of PTAs are often low. The Report also explains that:

“Onerous rules of origin procedures sometimes associated with free trade agreements have contributed to these low figures by making the costs of compliance requirements higher than the perceived worth of the underlying preference margins.”<sup>31</sup>

Similarly, research carried out by the World Bank showed that for the case of exports of African textiles to the EU and the U.S., more flexible and pragmatic ROOs could lead to a major increase in exports- there is potential for export volumes four times greater than what could be achieved by simply removing tariffs.<sup>32</sup>

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<sup>27</sup> Moshe Hirsch (2011), The Politics of Rules of Origin, in Broude, Tomer, Marc L. Busch and Amelia Porges (eds.), The Politics of International Economic Law, Cambridge University Press, 317-336. (LOOK UP REF. Used SSRN Paper for now: Mosche Hirsch, The Politics of Rules of Origin, The Hebrew University of Jerusalem Faculty of Law Research Paper No. 08-13, June 2013, at 327)

<sup>28</sup> “EU-South Korea FTA Negotiations: Resolution of Remaining Issues” (2011) European Automotive Manufacturers’ Association, [http://www.acea.be/news/news\\_detail/eu\\_south\\_korea\\_fta/](http://www.acea.be/news/news_detail/eu_south_korea_fta/) (last accessed at 17 April 2014)

<sup>29</sup> “EU-India FTA Negotiations: No Compromise on Zero-for-Zero” (2011), European Automotive Manufacturers’ Association, [http://www.acea.be/news/news\\_detail/eu\\_india\\_fta/](http://www.acea.be/news/news_detail/eu_india_fta/) (last accessed at 17 April 2014)

<sup>30</sup> WTO, World Trade Report 2011 The WTO and preferential trade agreements: From co-existence to coherence, 256 p. at 7.

<sup>31</sup> Ibid, at 44.

<sup>32</sup> Jaime de Melo and Alberto Portugal-Perez, Preferential Market Access Design: Evidence and Lessons from African Apparel Exports to the United States and the European Union, *The World Bank Economic Review*, Advance Access 7 June 2013, at 23.

#### 4. COMPLEX RULES LEADS TO UNDERUTILIZATION

Two interrelated characteristics of ROO, however, prompt businesses to ignore preferential treatment. First, ROO are complex, and adhering to origin rules can be cumbersome. A detailed study into ROO in PTAs revealed that the multiplicity of systems of ROO can be burdensome and an impediment to trade.<sup>33</sup> This is especially relevant as over the last twenty years, PTAs proliferated at an unprecedented rate, each of which contains different preferential ROO. This observation was also made by the World Economic Forum, which recognized that:

“PTAs could add to transactions costs in the absence of multilateral disciplines advancing in the WTO. Furthermore, PTA rules are based on an antiquated understanding of where goods are ‘from’ - hence the Byzantine networks of ‘rules of origin.’”<sup>34</sup>

Technical issues and related compliance challenges, in particular, play an important role in discouraging producers from taking advantage of preferences. Producers can face dilemmas when trying to obtain appropriate origin evaluation using Harmonized System (HS) codes. Producers even of basic goods or raw materials are plagued with reviewing HS codes (and any changes) and comparing these codes with the various phases of a good’s production to determine whether the possibility exists to keep or obtain originating status. Is it better to maintain existing originating classifications for a given product? Or should this classification be abandoned and a new origin assignment obtained? As stated above, HS codes serve as the primary means of evaluating changes in tariff classification for ROO applications —as benchmarks for “originating” and “non-originating” products. However, the system was not designed with this purpose in mind; instead, it was constructed to globally synchronize product classifications to facilitate trade data collection.<sup>35</sup> The application of these codes to origin determination is imperfect. And because the HS is constantly “changing and evolving,” “each time a new version enters into force, amendments have to be made to the rules of origin that are using the HS.”<sup>36</sup>

Inama, describing the fishing industry, provides an example indicative of this conundrum, illustrating the predicament fisheries have experienced when preparing products for export. If a fish is caught, transported to shore, and then cleaned and filleted, has there been a significant transformation of the original product? Is the cleaning and filleting of the wild fish enough to cause the fish to lose its original tariff classification?<sup>37</sup> Must the producer instead apply for a new tariff rate for the filleted fish, or are separate tariff rates applicable to the cleaned fish and the prepared fish?

ROO between NAFTA countries further exemplify these complexities. Shadikhodjaev mentions the Canada–US FTA and the US–Mexico FTA as examples of preferential trading arrangements that, because of the unmanageable ROO prescribed within them, prompt companies to forego trading benefits.<sup>38</sup> The same applies to the ROO prescribed by the European Union Generalized

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<sup>33</sup> M Donner Abreu (2013), *Preferential Rules of Origin in Regional Trade Agreements*, WTO Staff Working Paper ERSD-2013-05, 22 March 2013, 64 p. at 40.

<sup>34</sup> World Economic Forum (2012), *The Shifting Geography of Global Value Chains: Implications for Developing Countries and Trade Policy*, 2012, 40 p. at 9.

<sup>35</sup> Hironori Asakura, *The Harmonized System and Rules of Origin*, *Journal of World Trade*, Volume 27:4, 1993, pg. 5-21 at 20.

<sup>36</sup> See Inama (2009a), above n 8, at 422.

<sup>37</sup> Stefano Inama (2009b), “The Uruguay Round Agreement on Rules of Origin,” in *Rules of Origin in International Trade*, Cambridge University Press, New York, p.17-173 at 104.

<sup>38</sup> Sherzod Shadikhodjaev, “Duty Drawback and Regional Trade Agreements: Foes or Friends”, 2013 *Journal of International Economic Law*, Volume 16:3, 587-611, at 607; See also Joseph A. LaNasa III, *Rules of Origin and the Uruguay Round’s*

System of Preferences (GSP).<sup>39</sup> Applying for ROO among these countries requires an in-depth analysis of both the product being traded and the specifics of the ROO defined in the NAFTA agreements. Companies within all three countries risk reparation- in addition to non-preferential tariff rates- should ROO applications be wrongly prepared. Conditions for preferential treatment for any one good, however, vary across agreement partners: in this case, a Mexican company applying for preferential tariffs on automotive parts must navigate the US definitions of automotive parts as well as the Canadian definition before discerning the degree of product transformation and the HS classification of the product post-production processes within the Mexican firm. These complexities undermine tariff liberalization schemes established in PTAs and RTAs. Several studies have shown that ROO may lead to great difficulties in clearing customs, leaving preferences granted under GSP schemes unexploited.<sup>40</sup>

## **5. ORIGIN: TARIFF REDUCTION OR INCREASED BUSINESS COSTS?**

These complexities underscore a second, related characteristic of ROO that discourages utilization of preferential treatment: they are costly to apply. Companies participating in international exchange bear the costs of navigating ROO and ensuring compliance with each trading country's specific product classifications. Costs are threefold. First, costs come in the form of information required to process various Certificates of Origin. A business manufacturing one good (or parts for one good) potentially ship products to clients in multiple locations, requiring separate Certificate of Origin applications per each destination. In a recent speech at the World Customs Organization, Yoko Uenoyama of Japan's Panasonic Corporation documented her company's experiences: as manufacturers of hundreds of electronic components, equipment and finished across nine types of consumer goods, Panasonic cooperates or sells goods to more than 300 companies in 45 overseas countries and regions.<sup>41</sup> However, RTAs with these 45 regions and countries install unique terms for determining a product's origin; value-added, change in tariff classification, change in tariff heading, change in tariff sub-heading- any of these methods, or any combination of these methods can be used depending on the terms negotiated into the relevant RTA. Costs fall on firms to cope with researching appropriate information before applying for Origin status.

Second, assembling apposite information requires a preponderance of time. In the Panasonic example, employees must compile information on origin definitions from each pertinent RTA, cross check similarities between product definitions and HS codes in the destination country, and ensure that no changes to HS codes have occurred. This is a demanding task for any firm, costing exuberant amounts of employee hours to cross check products line-by-line against the fluctuating origin criteria. The logistics industry, in particular, is hampered by such procedures: while technology facilitates rapid movement of goods on a global scale, the time required to process all accompanying ROO documentation skews inhibits logistics companies from employing advanced transit processes, requires these firms to adjust business models to

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Effectiveness in Harmonizing and Regulating Them. American Journal of International Law, Volume 90, 1996, 625-640 at 626; Frederick P. Cantin and Andreas F. Lowenfeld, Rules of Origin, The Canada-U.S. FTA and the Honda Case, American Journal of International Law, Volume 87, 1993, 375-390 at 390.

<sup>39</sup> Paul Brenton (2006), "Enhancing Trade Preferences for LDCs: Reducing the Restrictiveness of Rules of Origin", in Richard Newfarmer (ed.), Trade, Doha and Development: A New Window into the Issues, Chapter 23, The World Bank, Washington, p. 281-287 at 283.

<sup>40</sup> Paul Brenton and Miriam Manchin, *Making EU Trade Agreements Work: The Role of Rules of Origin*. The World Economy, Volume 26:5, 755-769, July 2003 at 767.

<sup>41</sup> Yoko Uenoyama, "Promoting FTA Utilization." World Customs Organization, Brussels, Belgium, 21 January 2014. Session 6: What is Needed to Increase FTA Utilization? [www.wcoomd.org/en/events/upcoming-events/wco-origin-conference-2014/program.aspx](http://www.wcoomd.org/en/events/upcoming-events/wco-origin-conference-2014/program.aspx)

accommodate processing of origin materials, and delays smooth functioning of global production chains.<sup>42</sup>

Third, firms are liable for all irregularities associated with origin claims. Even after tiptoeing through tangled set of origin rules, definitions, and product classifications, origin applications can be denied, whether at the border or by customs authorities *a posteriori*. Where origin is denied, investments in Certificates of Origin are lost and business expenses rise. Moreover, firms are responsible for the discrepancies between preferential tariff rates and regular tariff rates where origin is denied, and authorities can collect these fines retroactively.<sup>43</sup> Trade secrets, too, are jeopardized: companies must adhere to strict documentation procedures and are financially responsible for tariff discrepancies should paperwork be incorrect; however, certificate of origin questions purge companies of valuable trade secrets when requesting detailed information concerning production processes or supplies.

## 6. TOWARD A VALUE-ADDED APPROACH

On a more fundamental level, ROO in their current incarnation do not reflect modern production processes. As trade becomes cheaper because of reduced transportation costs and improved production technologies, it is easier to relocate different stages of the manufacturing process to different areas of the world. Goods exchanged across borders, more importantly, are only fragments of final goods. “As supply chains go global,” notes Gereffi, “...more intermediate goods are traded across borders and more parts and components are imported for use in exports.”<sup>44</sup>

Today, a product’s assembly only accounts for approximately 10% of the total value of the final product (e.g. the consumer price) but this 10% determines the applied tariff rate. The remaining 90% of the final product’s value is not taken into account when determining the origin, and therefore the tariff. The Apple iPhone is an example often used in this particular situation. The iPhone is designed by Apple, whose headquarters are located in the USA, but manufactured in China from components originating from mostly countries other than China. Consequently, under applicable ROOs, the origin of the iPhone is conferred upon China. Kraemer, Linden and Dedrick show that manufacturing process in China adds as little as 1,8% to the final value of the end-product.<sup>45</sup> Recall that origin is most often determined using HS codes (a change of tariff heading), rather than through any assessment of value. This skews trade statistics, because the relative share of raw materials, R&D, intellectual property, and marketing are not factored into the total value of the product.<sup>46</sup>

Consequently, by using HS codes to allocate origin — and therefore tariff treatment —, the location of the manufacturing, production or assembly of the product confers on of assembly are no longer the most valuable part of the product. Presuming that the country where the most

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<sup>42</sup> See for example Dietmar Jost, “Express Delivery Services: A perspective from those who move Fast.” World Customs Organization, Brussels, Belgium, 21 January 2014. Session 4: Various Types of Proof of Origin. [www.wcoomd.org/en/events/upcoming-events/wco-origin-conference-2014/program.aspx](http://www.wcoomd.org/en/events/upcoming-events/wco-origin-conference-2014/program.aspx)

<sup>43</sup> Pablo Muñiz, “Managing the Risks in Utilizing FTAs.” World Customs Organization, Brussels, Belgium, 21 January 2014. Session 5: Origin Irregularities. [www.wcoomd.org/en/events/upcoming-events/wco-origin-conference-2014/program.aspx](http://www.wcoomd.org/en/events/upcoming-events/wco-origin-conference-2014/program.aspx)

<sup>44</sup> Gary Gereffi (2014), ‘Global value chains in a post-Washington Consensus world,’ *Review of International Political Economy*, Vol. 21(1): 9-37 at 19.

<sup>45</sup> Kenneth L. Kraemer, Greg Linden and Jason Decrick (2011), ‘Capturing Value in Global Networks: Apple’s iPad and iPhone’, PCIC Papers ‘Value of Innovation, available at [http://pcic.merage.uci.edu/papers/2011/Value\\_iPad\\_iPhone.pdf](http://pcic.merage.uci.edu/papers/2011/Value_iPad_iPhone.pdf) (Last Accessed at 17 April 2014).

<sup>46</sup> Yuqing Xing and Neal Detert (2011), ‘How The iPhone Widens the United States Trade Deficit with the People’s Republic of China’, ADBI Working Paper No. 257. Available at <http://www.adbi.org/files/2010.12.14.wp257.iphone.widens.us.trade.deficit.prc.pdf> (Last Accessed at 17 April 2014).

value is from could be the more logical choice for the determination of origin, the question should be posed whether policy decisions or economic development are hampered by the current ROO.

#### A. MULTILATERAL APPROACHES TO ROO HARMONIZATION

A broad critique of the flaws and inadequacies of ROO resonates in the international community, and multilateral forums have a good track record of discussing ROO reforms. The establishment of the ‘substantial transformation’ test, and the Agreement on ROO in 1994 constituted major achievements. Recently, though, lack of multilateral progress has led to reform proposals from various entities; these efforts origin determination has been left in practice to bilateral and plurilateral RTAs and PTAs.

In the early days of General Agreement on Tariffs and Trade (“GATT”), ROO were not, or only to a limited extent, included in the 1947 negotiations. Although the drafters of the Havana Charter recognized the importance of ROO for the smooth functioning of the future GATT, discretion for determining the origin of a certain good was left to the contracting parties. In 1952, the International Chamber of Commerce (ICC) recommended the GATT Contracting Parties adopt a common definition of the “nationality of manufactured goods.” The discussions among the GATT Contracting Parties did not lead to any results. Only in 1973 was the Kyoto Convention (see above) concluded under the auspices of the Customs Co-operation Council (CCC). The Kyoto Convention constituted the first effort at cementing the concepts of “nationality” (though the ICC suggested addressing this issue as early as 1952) and “substantial transformation,” two cornerstone concepts for conferring origin. Interestingly, ROO “remained the only one of three basic customs laws operating at the national level not subject to multilateral discipline” until the commencement of the Uruguay Round.<sup>47</sup>

In the 1980s, an increase in the number of RTAs, origin disputes, and anti-dumping laws triggered new efforts at reform.<sup>48</sup> These attempts materialized in the Uruguay Round negotiations of the GATT; unresolved discussions from the Kyoto meeting served as the basis for the ROO negotiations and paved the way for the Agreement on Rules of Origin (“Agreement on ROO”).<sup>49</sup> Article 1 of the Agreement on ROO provides that ROO are “laws, regulations and administrative determinations of general application” which determine the origin of a product to determine whether it falls within a non-preferential or a preferential trade regime.<sup>50</sup> The Agreement on ROO constituted the most comprehensive and thorough effort to date — multilateral or otherwise — to correct ROOs’ failings and to prevent ROO from further use as trade barriers. Most significantly, the Agreement on ROO settled the definitions of preferential and non-preferential origin, and the two committees formed under the auspices of the Agreement (The Harmonized Working Group and the Technical Committee on ROO) cemented definitions of “wholly obtained” and “substantial transformation of goods.”

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<sup>47</sup> Stefano Inama (2009c), “Efforts to Establish Multilateral Rules,” in *Rules of Origin in International Trade*, Cambridge University Press, New York, p.1-16 at 4.

<sup>48</sup> “Technical Information on Rules of Origin,” WTO | Rules of Origin – Technical Information (2013), [http://www.wto.org/english/tratop\\_e/roi\\_e/roi\\_info\\_e.htm](http://www.wto.org/english/tratop_e/roi_e/roi_info_e.htm)

<sup>49</sup> Multilateral Trade Negotiations - The Uruguay Round, Group of Negotiations on Goods, Rules of Origin – Communication from the European Communities, MTN.GNG/NG2/W/55, 5 February 1990, para. 4; Moshe Hirsch, ‘Agreement on Rules of Origin’, in Rüdiger Wolfrum, Peter-Tobias Stoll and Holger P. Hestermeyer (eds.), *WTO – Trade in Goods*, Max Planck Commentaries on World Trade Law, Martinus Nijhoff Publishers, 2011, at 1112.

<sup>50</sup> Article 1.2 Agreement on Rules of Origin further specifies that the ‘rules of origin referred to in paragraph 1 shall include all rules of origin used in non-preferential commercial policy instruments, such as in the application of: most-favored-nation treatment under Articles I, II, III, XI and XIII of GATT 1994; anti-dumping and countervailing duties under Article VI of GATT 1994; safeguard measures under Article XIX of GATT 1994; origin marking requirements under Article IX of GATT 1994; and any discriminatory quantitative restrictions or tariff quotas. They shall also include rules of origin used for government procurement and trade statistics.’

Year	Organizations/Institution	RoO Issue Discussed	Outcome related to RoOs
1952	International Chamber of Commerce	Defining Nationally Manufactured Goods	No Outcome
1967	UNCTAD Working Group on Rules of Origin	Origin rules specific to the Generalized System of Preferences	Meet 21 times but work was left incompleted when all UNCTAD special committees were eliminated in 1996
1973	Kyoto Convention/ Internation	Codify a general concept of orgin	Guidelines to what constitutes origin
1994	WTO Agreement on Rules of Origin	Establish the Harmonized Work Programme, the Committee on Rules of Origin and the Technical Committee on Rules of Origin to synchronize multilaterally RoOs and to increase transparency, predictability and consistency in the preparation and application of RoOs.	Defined the difference between preferential and non-preferential RoO systems. Defined "wholly obtained" and "substantial transformation" for deteremining a good's origin.
2005	WTO Hong Kong Ministerial	Harmonization of RoOs for Duty-Free Quota-Free initiatives	No outcome was reached on a harmonized definition of RoOs for DFQF programs

Sources: Inama (2009) and "Rules of Origin: Technical Information," available at [www.wto.org](http://www.wto.org)

In 2011, the WTO boosted its involvement in ROO issues by launching the 'Made in the World Initiative (MiWi)'. The 'Made in the World' initiative- a term first used by former WTO Director-General Pascal Lamy<sup>51</sup>- aims to support "the exchange of projects, experiences and practical approaches in measuring and analysing trade in value added."<sup>52</sup> The recent focus on trade in value added reflects the growing awareness among international organizations of the rapid changes in global manufacturing. An example of a project covered by the MiWi is the joint OECD-WTO Trade in Value-Added (TiVA) database, which aims to offer data and statistics that more accurately reflect today's global trade landscape. The initiative has attracted some criticism, dismissing the effort as an attempt to eliminate ROO.<sup>53</sup> However, the WTO has made it clear that the 'Made in the World' logo is only used to illustrate a statistical concept- the goal has never been to eliminate ROO, but rather to rethink the concept. Few dispute that some barriers should remain in place to prevent free riding and to ensure the justified parties and products benefit from RTA/PTA terms.<sup>54</sup>

The 'Made in the World' proposal is only one of many made over the years. The foregoing recommendations for reviewing and renewing ROO policies led to the convening of the Harmonized Work Programme (HWP) and the Agreement on the ROO under the auspices of the WTO, but recommendations have also appeared in regional organizations, as well as in reports from consultancies and private academic researchers. The European Commission weighed in on the debate by publishing a Green Paper in 2003 entitled "On The Future of Rules of Origin in Preferential Trade Agreements."<sup>55</sup> The paper summarizes key problems posed by the current ROO structure and names three key areas where rebalancing is needed: first, the criteria for acquiring origin and the legal framework surrounding the process for acquiring origin; second, greater supervision is demanded in applying origin assignments; and third, a procedure for ensuring an optimal division of responsibilities is needed to balance the burden for traders and authorities.<sup>56</sup> As such, the Green Paper deals more with compliance issues than with proposals for the substantive reform of ROO.

<sup>51</sup> WTO, 'Lamy says more and more products are "Made in the World"', 15 October 2010. Available at [http://www.wto.org/english/news\\_e/sppl\\_e/sppl174\\_e.htm](http://www.wto.org/english/news_e/sppl_e/sppl174_e.htm) (last accessed at 17 April 2014).

<sup>52</sup> The core objectives have been characterized as (i) promoting the development of trade in value-added statistics; and (ii) mainstreaming the implications of GVCs and the "Made in the World" reality on trade policy

<sup>53</sup> MICHELE NASH-HOFF, CHANGING TO WTO'S 'MADE IN THE WORLD' LABELING WOULD HARM AMERICANS, THE HUFFINGTON POST, 22 MAY 2012.

[http://www.huffingtonpost.com/michele-nashhoff/changing-to-wtos-made-in- b\\_1536758.html](http://www.huffingtonpost.com/michele-nashhoff/changing-to-wtos-made-in- b_1536758.html) (last accessed 17 April 2014).

<sup>54</sup> See van de Heetkamp and Tusveld, above n 3, at 183.

<sup>55</sup> European Commission (2003), "On the Future of Rules of Origin in Preferential Trade Agreements", COM (2003) 787 final.

<sup>56</sup> Ibid, at p. 5.



In subsequent years, the Commission published a number of other proposals, which ultimately resulted in reformed ROOs for the Generalized System of Preferences.<sup>57</sup> Although the European Commission favoured a value-added percentage requirement as the basis for the determination of a substantial transformation for some time, the basic rules on the conferral of origin eventually remained the same. Opposition from certain sectors – agriculture, fisheries and textiles – against a general value-added approach partially explains the lack of radical reform. As Naumann concludes, the revised GSP ROOs “thus continue to favour a tailored and often line-by-line approach on the issue of determining origin albeit that it recognises that ‘the rules of origin should as far as possible be on a sector-by-sector rather than a product-by-product basis’.”<sup>58</sup>

In the context of the WTO’s Doha Development Round, the Bali Ministerial Conference saw the adoption of a Ministerial Decision on Preferential Rules of Origin for Least-Developed Countries.<sup>59</sup> The decision is based on a proposal by the group of Least-Developed Countries (LDC Group).<sup>60</sup> It stresses the need for transparent, simple and objective preferential ROO. Where the change in tariff classification criterion or the specific process criterion are used, the rule must require compliance with simple operations; where Members adopt a value-added criterion, the proposal calls upon Members to adopt percentage-levels that reflects the limited production capacity in LDCs.<sup>61</sup>

Impasse at the multilateral level inspired more creative solutions outside traditional international or governmental negotiations. A recent and innovative approach to resolving ROO comes from Michitaka Nakatomi, who proposed the development of an International Supply Chain Agreement (“ISCA”). Nakatomi implores a turn away from all-encompassing PTA/RTA negotiations and redirecting multilateral focus on issue-specific agenda items.<sup>62</sup> Supply chain rules, he suggests, are a first target for such an approach: as central elements of modern-day production processes, supply chains are poorly accounted for in the “spaghetti bowl” of trade regulations negotiated into current “mega-regionals.” An ISCA could harmonize ROO and ease requirements for multi-stage production processes. It would incorporate business and industry perspectives directly into the negotiating rounds; complement far-reaching multilateral efforts under the WTO; and constitute a first step toward overcoming the complications sparked by unsynchronized origin rules. However, concrete details of the envisaged agreement remain to be outlined. At this point, the extent to which such an agreement can really contribute to harmonizing broader trade rules is unclear.

Thus, in spite of grave implications for current trade patterns and modern economic structures, ROO as conceived in the 1940s remain the standing order in determining both a good’s geographic origin and the applicable tariff rate. Attempts at reforming both preferential and non-

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<sup>57</sup> Commission Regulation (EU) No 1063/2010 of 18 November 2010.

<sup>58</sup> Eckart Naumann (2011), “The EU GSP Rules of Origin: An Overview of Recent Reforms”, Tralac Working Paper No. S11WP12/2011, November 2011, at 6.

<sup>59</sup> WTO, Ministerial Conference, Ninth Session, Bali, 3-6 December 2013, “Preferential Rules of Origin for Least-Developed Countries, WT/MIN(13)/42, WT/L/917, 11 December 2013.

<sup>60</sup> WTO, Trade Negotiations Committee, Ninth WTO Ministerial Conference, Bali, Indonesia, 3-6 December 2013, LDC Package for Bali, Communication by Nepal, On Behalf of the LDC Group, TN/C/W/63/Add.1, 17 September 2013, at 2; See WTO, Trade Negotiations Committee, Ninth WTO Ministerial Conference, Bali, Indonesia, 3-6 December 2013, LDC Package for Bali, Communication by Nepal, On Behalf of the LDC Group, TN/C/W/63, 31 May 2013, at 4-11.

<sup>61</sup> WTO, Ministerial Conference, Ninth Session, Bali, 3-6 December 2013, “Preferential Rules of Origin for Least-Developed Countries, WT/MIN(13)/42, WT/L/917, 11 December 2013, par. 1.2 and 1.6.

<sup>62</sup> Michitaka Nakatomi (2013), “Plurilateral Agreements: A Viable Alternative to the World Trade Organization?”, ADBI Working Paper No. 439, October 2013. Available at <http://www.adbi.org/files/2013.10.24.wp439.plurilateral.agreements.alternative.wto.pdf> (last accessed at 17 April 2014). See also Michitaka Nakatomi (2012), “Concept Paper for an International Supply Chain Agreement (ISCA): Improving global supply chains by an issues-based plurilateral approach,” Research Institute for Economy, Trade and Industry, Japan.



preferential ROOs have sprouted across international economic fora, but real reform of ROO is yet to transpire. To fill this gap, a new approach is needed, one that facilitates the standing contours of international production and exchange while preserving the integrity of politically negotiated trade agreements.

#### B. BILATERAL RELATIONS: A NEW STARTING POINT FOR ROO REFORM

Multilateral organizations like the WTO, the WCO and the Organization for Economic Co-operation and Development (“OECD”) have worked hard at reconciling the factors complicating the application of ROO in both preferential and non-preferential spheres, but multilateral approaches have, to date, proven ineffective.<sup>63</sup> While regional and multilateral organizations recognize the complications connected with determining origin and ROO application and have tried to eradicate them, the key challenge now lies in the bilateral nature of preferential ROO. This, perhaps, suggests the roots for a new approach to resolving and harmonizing ROO: target the source of the problem and attempt reform at the bilateral level. This level may be the best place to overhaul ROO, emphasizing not the location of manufacturing and assembly (now a misleading concept), but the location where the most value is added to the final product, perhaps as determined by the customs value. Having discussed the respective strengths and weaknesses of several ROO reform proposals, attention here centers on elaborating an innovative solution grounded in bilateral agreements.

As noted above, both non-preferential and preferential ROO currently base their origin determination on a number of criteria closely related to the actual manufacturing or assembly of the final product. Because these criteria misfire when examining products produced in multiple steps at multiple locations, the concept of ROO must be rethought. Moreover, the majority of goods traded on the world market- within GVCs, between them, and otherwise- are intermediate goods, products that are component to other intermediate goods or elements of a final good.<sup>64</sup> Determining the exact step where a product is “made,” then, is inherently cumbersome, as all steps contribute significantly to the sales price of the final good. Beyond the place of the ‘last substantial transformation’ or actual manufacturing operations, modern ROO must factor the value (and the location) of the design, R&D, marketing, transport, and perhaps even the sales (retail) of the final product. Ultimately, these steps in the production process are equally, if not more, important than the mere assembly of the product. Moreover, these steps contribute significantly to the good’s overall value. Indeed, the value added at these steps generally exceeds the value of the production or assembly activities.

Should this new approach to origin determination be taken, several questions present themselves. First, what would be the design of a rule conferring origin based on value added at each step in the production process? Second, what steps in the production process would qualify for inclusion, and how would the relative value-add be measured? To this end, a few preliminary answers can spark or reignite debate on the best way to effectively reform ROOs.

On the question of design, a rule could stipulate that [both preferential and non-preferential?] origin be conferred if 50% of the final value of the product, measured as the customs value, originates in the territory of one country. Alternatively, because it can be difficult to specify a ‘final’ consumer — goods may be sold several times — one could argue for 50% of the value of the product at the moment that it crosses a given border, i.e. the price paid by the importer of the

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<sup>63</sup> Wim Keizer, *Negotiations on Harmonized Non-Preferential Rules of Origin – A Useless Task from a Trade Policy Perspective?* 1997 *Journal of World Trade* (31)(4) 145-151 at 150.

<sup>64</sup> See Gereffi, above n 44, at 14.

product after crossing of that border.<sup>65</sup> Consider the current language (a clause) commonly found in PTAs:

**ARTICLE 6.1: ORIGINATING GOODS**

Except as otherwise provided in this Chapter, each Party shall provide that a good is originating where it is:

- (a) a good wholly obtained or produced entirely in the territory of one or both of the Parties;
- (b) produced entirely in the territory of one or both of the Parties and
  - (i) each of the non-originating materials used in the production of the good undergoes an applicable change in tariff classification specified in Annex 4-A (Specific Rules of Origin for Textile or Apparel Goods) or Annex 6-A, or
  - (ii) the good otherwise satisfies any applicable regional value content or other requirements specified in Annex 4-A or Annex 6-A, and the good satisfies all other applicable requirements of this Chapter; or
- (c) produced entirely in the territory of one or both of the Parties exclusively from originating materials.<sup>66</sup>

The text highlights that a good's 'production' stage is centrifugal to origin determination. To make the language more aligned with modern production cycles and GVCs, a new clause could read:

"Except as otherwise provided, each Party shall provide that a good is originating where:

- (a) It is a good wholly obtained or produced entirely in the territory of one or both of the Parties;
- (b) More than 50% of the final value of the good, as determined by the customs value, has been added in the territory of one of the parties, taking into account the following stages of the production process: research and development, design, intellectual property, manufacturing, marketing;
- (c) The majority of the final value of the good – as determined by the customs value – has been added in the territory of one of the parties, taking into account the following stages of the production process: research and development, design, intellectual property, manufacturing, marketing;"

If this offers a possible answer to the design question, it immediately raises a second: what factors should be taken into account for determination of value and how is the added value to be documented for each step in the production process? Is the sales price an adequate measure? Currently, R&D and marketing costs may not be truly reflected in the sales price of a product. For example, the value-based origin of a shoe produced on machinery written off for depreciation, or a shoe marketed by a well-established brand, may differ from that of a shoe produced in a new factory and marketed by a new brand.

Assuming that multiple, value-add steps are taken into account in origin determination, including factors such as the design, R&D, and marketing, how would this affect trade and trade policy? Would the potential benefits of these ROO reform outweigh the possible risks? This question is

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<sup>65</sup> We opt for the price paid by the importer of the product after the border as this offers an objective measurement at a certain point in time. Products may be re-sold many times before reaching the final consumer, making it difficult to use the consumer price as a measurement. Although retail inevitably also adds to the final value of a product, by using the price of the good upon importation, the value added by retail is discarded. However, the intricacies attached to calculating this factor are considered too complex. For example, the cost of, and value added by, retail may depend on the number of goods eventually sold.

<sup>66</sup> U.S. – Korea Free Trade Agreement, Final Text, Chapter 6 Rules of Origin and Origin Procedures, Article 6.1.

vast and only preliminary answers can be offered. It is likely that more products would be found to originate in one of the developed economies (EU, U.S., Japan). Developed countries would thus have to forego customs duties on many products. On the other hand, imported products from non-partner countries would be of far greater value and thus be subject to higher customs duties, retaining origin's importance and potentially offsetting budgetary consequences. Second, as suggested above, reduced customs duties on many products could lower consumer prices and stimulate demand.

Consider two examples: a Nike T-shirt and an Apple iPhone. The T-shirt now originates in Bangladesh and is subject to customs duties upon importation. However, under reformed ROO rules, design, and marketing would be taken into account when calculating the proportion of value-add within the consumer price. In this scenario, the T-shirt would longer originate in Bangladesh, but in the U.S., and hence be free from customs duties in the U.S. but subject to higher duties upon import to (for instance) the EU. The iPhone now originates in China, but only because China is the location of assembly. The assembly or value-added in China is only 1,8% of the consumer price, so most of the value comes from the U.S.<sup>67,68</sup> However, a company importing the product into the U.S. might have to pay customs duties linked to that product's origin in China. Under the revisions proposed in this article, the R&D, design, and marketing of the product would be taken into account when determining origin, and the iPhone might very well be found to originate in the U.S or in Korea.

Due to the overwhelmingly bilateral nature of preferential ROOs, this approach would ideally be tested in a PTA, perhaps a PTA negotiated by the EU or US with one of their smaller trading partners. Importantly, this proposal for bilaterally clarifying ROO would not undermine the concept, nor does it imply the abolition of the ROO system.

## **7. CONCLUSIONS**

On the surface, ROO appear a valiant mechanism for upholding the terms negotiated in RTAs, allowing companies to reduce business costs and profit from advancements in production processes while protecting markets from profiteering enterprises. A deeper look into the issue reveals that a marked disconnect exists between politically negotiated trade agreements and the realities of modern business conditions. Resultantly, the ambiguities surrounding the use of ROO lead firms to forgo favorable tariff rates.

This paper proposes simplifying the issue in a 'grassroots' manner- by starting at the bilateral level rather than the multilateral level, renegotiating origin determination processes foregoes standard political hiccups and concentrates efforts on accounting for the economic realities characteristic of today's international marketplace. Whereas the current ROO system employs changes in tariff heading, in tariff sub-headings, in tariff classifications *or* value-added methods for assigning origin, proposals here rely on a value-added determination, relegating origin to the country where the greatest value is added to the overall product price.

Such a proposal is neither a simplification of multilateral efforts nor a Band-Aid for a grander problem; instead, and similar to rampant proliferation of bilateral agreements over the last three decades, reforms rooted in bilateral RTAs connect the political realities of modern economic governance to modern conditions characteristic of production and manufacturing.

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<sup>67</sup> See Kraemer, Linden and Decrick, above n 45.

<sup>68</sup> See Gereff, above n 44.

### Appendix 1: Comparison of EU and US Rules of Origin across Sectors

Sector	Description of product	CN code	EU non-preferential rules of origin	US preferential of origin non-rules	EU GSP rules of origin	US GSP rules of origin
<b>Textiles</b>	Shirt of cotton	6105 10 00	<u>Complete making up rule:</u> all production operations following cutting, knitting or crocheting of the fabric directly to shape must be performed in the country. Making-up shall not be considered complete where one or more finishing operations have not been carried out (ex. fitting of buttons).	<u>Substantial transformation rule:</u> the location where a garment is cut and sewn confers origin (although assembly alone can confer the origin for garments that are not knit to shape).	(a) LDCs: <u>manufacture from fabric;</u>  (b) Other beneficiary country: <u>knitting and making up.</u>	<u>"Yarn-forward" rule:</u> tariff shift test that requires, through a tariff shift, that textile and apparel products must originate in a beneficiary country from the yarn stage forward (fibers may come from anywhere).
<b>Automotive</b>	Car with cylinder 1000-1500 cm <sup>3</sup>	8703 22 10	<u>60% value added rule:</u> Manufacture where the increase in value acquired as a result of working and processing, and if applicable, the incorporation of parts originating in the country of manufacture represents	<u>Substantial transformation rule:</u> the origin of the good is determined to be the last place in which it was substantially transformed into a new	(a) LDCs: manufacture in which the value of all materials used does not exceed 70% of the ex-works price of the product;  (b) Other beneficiary countries: manufacture in which the value of all the materials used does not exceed 50% of the ex-works price of the product.	The sum of (1) the cost or value of materials produced in that beneficiary developing country (or produced in one or more members of an association of countries treated as one country under the GSP),

			at least 60% of the ex-works price of the product.	and distinct article of commerce based on a change in name, character, or use.		plus (2) the direct costs of processing operations performed in that beneficiary developing country (or in one or members of an association of countries treated as one country under the GSP), is at least 35 % of the appraised value of the article.
<b>Electronics</b>	Television receivers - LCD screen	8528 59 40	<u>45% value added rule</u>  When the 45% rule is not met, the apparatus shall be treated as originating in the country of origin of parts whose ex-works price represents more than 35% of the ex-works price of the apparatus.  When the 35% rule is met	<u>Substantial transformation rule:</u> the origin of the good is determined to be the last place in which it was substantially transformed into a new and distinct article of commerce based on	(a) LDCs: manufacture from materials of any heading, except that of the product of heading 8529 (parts) or Manufacture in which the value of all the materials used does not exceed 70% of the ex-works price of the product;  (b) Other beneficiary countries: manufacture from materials of any heading, except that of	The sum of (1) the cost or value of materials produced in that beneficiary developing country (or produced in one or more members of an association of countries treated as one country under the GSP), plus (2) the direct costs of processing operations

			in two countries, the apparatus shall be treated as originating in the country of origin of parts representing the greater percentage value.	a change in name, character, or use.	the product of heading 8529 (parts) or Manufacture in which the value of all the materials used does not exceed 50% of the ex-works price of the product.	performed in that beneficiary developing country (or in one or members of an association of countries treated as one country under the GSP), is at least 35 % of the appraised value of the article.
<b>Medicines</b>	Drug medicaments in measured doses containing antibiotics	- 3004 20 00	<u>"Change of Tariff Heading"</u> (CTH) rule, except by mere pressing of tablets or by mere encapsulation.	<u>Wholly obtained or substantial transformation rule</u>	<u>Manufacture from materials of any heading:</u> materials of any heading (even materials of the same description and heading as the product) may be used.	The sum of (1) the cost or value of materials produced in that beneficiary developing country (or produced in one or more members of an association of countries treated as one country under the GSP), plus (2) the direct costs of processing operations performed in that beneficiary developing

country (or in one or members of an association of countries treated as one country under the GSP), is at least 35 % of the appraised value of the article.



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